

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

In the Matter of

Review of the Commission's Rules)	
Regarding the Pricing of Unbundled)	WC Docket No. 03-173
Network Elements and the Resale of)	
Service by Incumbent Local Exchange)	
Carriers)	

**COMMENTS OF ALLEGIANCE TELECOM, INC.,
CBEYOND COMMUNICATIONS, LLC,
CHOICE ONE COMMUNICATIONS INC.,
EL PASO NETWORKS, LLC,
FOCAL COMMUNICATIONS CORPORATION,
MCLEODUSA TELECOMMUNICATIONS SERVICES, INC.,
PACWEST TELECOMM, INC.
TDS METROCOM, LLC**

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SUMMARY

Allegiance Telecom, Inc, Cbeyond Communications, LLC, ChoiceOne Communications Inc., El Paso Networks, LLC, Focal Communications Corporation, McLeodUSA Telecommunications Services, Inc., PacWest Telecomm, Inc., and TDS Metrocom, LLC, are facilities-based CLECs that use unbundled access to loops and transport in combination with their own facilities to provide competitive local exchange services in their respective markets throughout the United States. These companies fully support the Commission's goal of promoting facilities-based competition and efficient investment. To the extent the Commission modifies its UNE pricing rules, it should do so in ways that will more accurately reflect costs for the essential, hard to duplicate facilities –loops and transport – for which the Commission has determined that impairment exists. Because of impairment for these facilities, higher prices would not promote investment but simply retard competition, the overarching regulatory goal of incumbents in this proceeding.

The *Triennial Review Order* has invalidated ILECs' arguments in favor of UNE pricing relief. In light of the Commission's elimination of unbundled access to ILECs' "next generation" broadband networks, there is no basis for adjusting UNE prices to promote broadband investment. Nor could there be any basis for promoting investment in the supposedly soon-to-be obsolete "legacy" networks by either incumbents or CLECs. Almost by definition, encouraging investment in such technology would be inefficient.

As contended by these companies and others on appeal of the *Triennial Review Order*, the Commission's decision to limit CLEC access to only the "legacy" network is unlawful for a number of reasons. However, a refinement of UNE pricing rules is appropriate as recommended

in the attached Report from Bridger Mitchell, Charles River Associates (“Mitchell Report”) even if those rules will only apply to the “legacy” network. The Commission should retain and validate again the forward looking approach of UNE pricing but consider modifying TELRIC to establish an approach to setting UNE prices that will more accurately reflect forward-looking pricing in a number of respects. These modifications will promote facilities-based competition by producing lower UNE prices for the facilities - loops and transport - that CLECs for the most part are unable to replicate.

In addition to the impact of the *Triennial Review Order*, there is no need to revise TELRIC to promote investment because current rules have stimulated a huge investment in new telecommunications infrastructure by both incumbents and CLECs. This investment is continuing. The TELRIC rules also permit incumbents to recover their costs including a reasonable profit.

Cost allocation between broadband and other services exempt from unbundling and legacy services riding the same network create a significant opportunity for incumbents to subsidize broadband. To the extent the Commission’s broadband rules remain in place, the Commission should prescribe allocators that will produce lower prices for loops and transport.

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Allegiance Telecom, Inc, ("Allegiance"), Cbeyond Communications, LLC ("Cbeyond"), ChoiceOne Communications Inc. ("ChoiceOne"), El Paso Networks, LLC ("El Paso"), Focal Communications Corporation ("Focal"), McLeodUSA Telecommunications Services, Inc. ("McLeodUSA"), PacWest Telecomm, Inc. ("PacWest"), and TDS Metrocom, LLC ("TDS") ("Commenters") submit these comments in response to the September 15, 2003 Notice of Proposed Rulemaking.¹

¹ *In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers. WC Docket No. 03-173, Notice of Proposed Rulemaking, FCC 03-224 (September 15, 2003) ("TELRIC NPRM").*

I. THE DECISION IN THE *TRIENNIAL REVIEW ORDER* TO LIMIT UNBUNDLING FOR BROADBAND INVALIDATES ILEC ARGUMENTS THAT PRICING RELIEF IS NECESSARY (*NPRM*, § IV.A.1)

As stated in comments in the *Triennial Review Proceeding*, the argument that unbundling relief is necessary or appropriate to stimulate ILEC investment in broadband never had any validity.² ILECs are trying to manipulate regulators by threatening to withhold further broadband investment,³ and, empirical evidence shows that it is competition, not immunity from competition, that promotes new investment. The incentives for investment and innovation are greater in a competitive environment because ILECs will be prodded to use investment as a competitive tool to defend and take market share from competitors. For instance, ILECs possessed DSL technology in the early 90s but refused to roll it out so as to not cannibalize its T1 product. Once competition materialized from CLECs and cable companies, ILEC investment in DSL “exploded.”⁴

Similar to the DSL experience, ILECs offered ISDN only sparingly in the 1980s even though the technology was developed in the 1970s because there was nothing to prod the ILECs to deploy it.⁵ Bruce Mehlman, the assistant Commerce Secretary, Office of Technology Policy, noted in a recent speech that RBOCs now have reduced incentives to invest in broadband data

² See, e.g., CC Docket No. 01-338, Comments of ALTS, *et al.* at 9-15 (April 5, 2002) and Reply Comments of ALTS, *et al.* at 16-19 (July 17, 2002).

³ CC Docket No. 01-338, AT&T Comments at 75.

⁴ WC Docket No. 03-173, Letter from Joan Marsh, Director, Federal Government Affairs, to Marlene Dortch, Secretary, FCC, Robert D. Willig Essay at 3.6 (December 5, 2003) (“Willig Essay”)

⁵ CC Docket No. 01-338, AT&T Comments at 74.

since there is less competition from CLECs.⁶ As Rep. Markey noted in hearings before the Senate Commerce Committee, competition also spurs technological innovation.⁷

In any event, there can now be no basis for modifying TELRIC pricing in order to promote broadband because the Commission has determined that ILEC broadband network elements are not subject to unbundling. The fact that competitors will have limited, if no, access to RBOC investment in new broadband facilities renders moot the need for any UNE pricing relief to promote investment in those facilities.

Never satisfied, ILECs, in light of broadband unbundling relief, are now asking for pricing relief for the “legacy” network. Commenters submit that, by definition, there is no basis for UNE pricing relief to promote investment in the legacy network. Accordingly, it would be irrational, and therefore, unlawful for the Commission at this point to provide pricing relief to promote investment in the legacy network. Because broadband investment has been the foundation of ILEC requests for pricing relief, the Commission should not modify TELRIC except to the extent necessary to produce lower pricing for loops and transport as recommended in the attached report from Bridger Mitchell, Charles River Associates (“Mitchell Report”).

It is also worth noting that even assuming *arguendo*, that the Commission in establishing UNEs is allowed to consider factors such as promoting ILEC investment pursuant to the “at a minimum” language of Section 251(d)(2) there is no such corollary discretion in regard to determining prices for unbundled network elements. The Commission is mandated to implement rules that will provide cost-based rates for UNEs. The only impact on ILECs that the

⁶ *Bush Still Undecided on Broadband Policy*, Communications Daily, Vol. 22, No. 100 at 1 (May 23, 2002).

⁷ Communications Daily, Vol. 22, No. 100 at 5 (May 23, 2002).

Commission may take into account is whether the rates are confiscatory. Since both this Commission and the Supreme Court have already unequivocally determined that TELRIC does not produce rates that are confiscatory on their face, and have also determined that TELRIC pricing provides adequate cost recovery for ILECs,⁸ modifying pricing to promote investment controverts the requirements of the Act.⁹ The Supreme Court noted that “while it is true . . . that the Act was ‘deregulatory’ in the intended sense of departing from traditional ‘regulatory’ ways that coddled monopolies . . . that deregulatory character does not necessarily require the FCC to employ passive pricing rules deferring to incumbents’ proposed methods and cost data.”¹⁰

⁸ *Review of the Section 251 Unbundled Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, *Deployment of Wireline Services Offering Advanced Telecommunications Capacity*, CC No. 98-147, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, FCC 03-36, ¶ 582 (rel. August 21, 2003) (“*Triennial Review Order*”); *Verizon Communications, Inc. v. FCC*, 122 S.Ct. 1646, 1677-1678 (2002) (“*Verizon*”).

⁹ Indeed, not only would it be unlawful under the Act to devise a pricing scheme that is based on anything but the ILEC’s cost, but it would be wholly contrary to the Commission’s stated goal of ridding the industry of implicit subsidies in pricing were the Commission to devise a pricing rule designed to subsidize the RBOCs investment in a new network to which the CLECs would not have access.

¹⁰ *Verizon*, 122 S.Ct. at 1668, n. 20.

II. *TRIENNIAL REVIEW ORDER* UNE RESTRICTIONS SHOULD REDUCE UNE PRICES (*NPRM*, § IV.A.2.)

The restrictions on access to UNEs adopted in the *Triennial Review Order* require a reduction in UNE prices. The Commission in the *Triennial Review Order*, in effect, relegated CLEC access to the ILEC “legacy” networks while essentially freeing to some extent new broadband network deployment by the ILECs from unbundling.

As long as this approach continues in effect, cost studies and UNE pricing must take into account the fact that CLECs will not be obtaining full access to these broadband facilities. For instance, if fiber-fed DLC technology is the most efficient technology currently available and the appropriate forward-looking technology on which to base recurring loop costs, some modification must be made to reflect the fact that CLECs are not getting access to the full capabilities of these facilities. Some cost allocation must be made of the common costs and the network investment costs incurred to deploy both narrowband and broadband services over these facilities. Since CLECs in some circumstances may only obtain unbundled access to the TDM or narrowband capabilities of fiber facilities, UNE prices must be based on an appropriate allocation of just the narrowband capabilities of the facilities.

Moreover, the case for a higher risk-associated cost of capital and accelerated depreciation schedule, which is already tenuous for some newer technology, is inapplicable to older, hard-to-duplicate technology. The Supreme Court noted that the case for raising depreciation rates is particularly weak for loops. The Court observed:

The local-loop plant makes up at least 48 percent of the elements incumbents will have to provide, see First Report and Order ¶ 378, n. 818 (“As of ... 1995 ... [l]ocal loop plant comprises approximately \$109 billion of total plant in service, which represents ... 48 percent of network plant”), and while the technology of

certain other elements like switches has evolved very rapidly in recent years, loop technology generally has gone no further than copper twisted-pair wire and fiber-optic cable in the past couple of decades. See n. 10, *supra* (less than 1 percent of local-exchange telephone lines employ technologies other than copper or fiber). We have been informed of no specter of imminently obsolescent loops requiring a radical revision of currently reasonable depreciation.¹¹

Likewise, ILECs will face substantially less competitive risk in regard to their legacy networks.

Thus, there is no basis for a higher cost of capital for the elements that CLECs are able to access only for narrowband services. Limited access to broadband capabilities supports a differentiated cost-of-capital by UNE proposed in the Report of Bridger Mitchell (“Mitchell Report”), and discussed further below.¹²

¹¹ *Verizon*, 122 S.Ct. at 1678.

¹² See Attachment, Report of Bridger Mitchell, Charles River Associates at 14-15. (“Mitchell Report”)

III. WHERE THERE IS IMPAIRMENT, HIGHER UNE PRICES WOULD NOT PROMOTE FACILITIES-BASED COMPETITION (*NPRM*, § IV.A.1.)

In the *Triennial Review Order*, the Commission determined that CLECs face impairment for loops and transport, among other network elements. As part of this determination, the Commission found that CLECs were for the most part unable to self-provision these facilities and needed to lease them as UNEs. Thus, raising the prices of these UNEs will do nothing to lead to additional deployment of facilities. If the reduced margins caused by higher UNE prices render UNE leasing uneconomic, then the CLEC will forego serving the customer. As the Department of Justice noted in the *Local Competition Proceeding*, “pricing above forward-looking costs would subject competitors to substantial risk of a price squeeze because the real cost of a network element for the incumbent LEC will be its forward-looking economic cost, while the cost to the new entrant will be the higher price charged for the element by the LEC.” *Local Competition Order*, ¶ 635. Raising prices above TELRIC costs will only serve to dampen CLEC investment because CLECs, by definition, will be unable to self-provision economically network elements for which the Commission has made a finding of impairment, or compete effectively if prices are set above TELRIC. CLECs will be unable to overcome the tremendous advantages that ILECs possess.¹³

¹³ Willig Essay at 3.3 (Noting that ILECs enjoy enormous advantages as a result of their legacy as protected franchise monopolists including economies of scale and scope and first mover advantages).

IV. A MAJOR OVERHAUL OF PRICING RULES TO FOCUS ON EXISTING NETWORKS OR “ACTUAL” COSTS SHOULD NOT BE ADOPTED

A. “Actual” Cost Or Existing Network Approaches Are Impractical To Implement (*NPRM*, ¶ 7)

The *TELRIC NPRM* suggests that TELRIC functions as a “black box” because it lacks objective criteria or standards on which to base rates and, accordingly, provides considerable latitude to set rates without regard to costs.¹⁴ However, TELRIC is not inordinately complex or difficult to administer in comparison to other cost-based ratemaking methodologies, none of which are particularly simple or straightforward. As the Commission noted at the time of its implementation of TELRIC, a number of states had already implemented forward-looking costing methodologies to set prices for interconnection and unbundled network elements or support the use of such an approach.¹⁵ A number of European jurisdictions also use long run incremental cost approaches.¹⁶ Agencies increasingly use forward-looking cost methodologies based on economic modeling to set rates.¹⁷

In fact, an actual cost methodology may be the more speculative of the two methodologies. Under an actual cost approach, one must not only determine the actual costs but also if they were prudently incurred. Rate-of-return regulation based upon prudently incurred

¹⁴ *TELRIC NPRM*, ¶ 7.

¹⁵ *Local Competition Order*, ¶ 681.

¹⁶ See Commission of the European Communities, *Ninth Report on Implementation of the EU Electronic Communications Regulatory Package*, Annex 2 (2003).

¹⁷ *American Public Gas Ass’n v. FPC*, 567 F.2d 1016, 1036-1037 (D.C. Cir. 1977) (courts “have approved the use of . . . hypothetical cost projection for some producers, as a means of arriving at a reasonable individual rate”).

historical costs requires numerous estimates and predictive judgments.¹⁸ Thus, regardless of the methodology used, significant estimations and future cost predictions need to be made.¹⁹ The estimations required in TELRIC are clearly not out of line with those that are a standard feature of ratemaking.

Even Justice Brandeis, who was skeptical about the speculative nature of estimating reproduction costs, noted that:

estimating reproduction cost was useful and appropriate “as a means, either of supplying lacks in the proof of actual cost and investment, or of testing the credibility of the evidence adduced, or of showing that the cost of installation had been wasteful,” and instances such as “when book values, or property accounts, furnish[] no trustworthy evidence either of cost or of real value.”²⁰

In regard to pricing for interconnection and unbundled network elements, the situation Justice Brandeis described exists. As has been noted:

¹⁸ As economists have observed:

[I]t is uncertain as to whether the factual inquiry required for the conduct of a proper TELRIC study is any more hypothetical in nature than the judgments called for in determining whether or not capital costs, some of which were incurred decades ago, were “prudently” made or are “used and useful.” Both the prudent and used and useful standards require an agency or court to ascertain the prospective demand for the products that will use the utility’s facilities, the cost of alternative technologies, and the life-cycle costs of the facilities. All of these factors require considerable speculation and by definition are hypothetical in nature.

David Gabel and David Rosenbaum, *Who’s Taking Whom: Some Comments and Evidence on the Constitutionality of TELRIC*, 52 Fed. Comm. L.J. 239, 254 (2000) (“Gabel/Rosenbaum”).

¹⁹ *Town of Norwood v. FERC*, 53 F.3d 377, 380 (D.C. Cir. 1995). As the D.C. Circuit observed in *Norwood*, “long-range estimates are an integral feature of ratemaking and financial analysis in general, and we have regularly approved reliance on admittedly imperfect future cost estimates.” *Norwood*, 53 F.3d at 380.

²⁰ *Gabel/Rosenbaum* at 255.

The problem with this [historical cost methodology] is that the accounting systems currently used by the ILECs do not contain the data that is required for making pricing decisions regarding the provision of UNEs and the pricing of interconnection. These accounting systems were largely designed to track the financial standing of the corporation. Accounting data is typically not maintained at a level of granularity that is sufficient for determining the cost of individual components of the network or tariff elements.²¹

The RBOCs' actual cost/existing network approach may thus be more hypothetical than the FCC's TELRIC methodology. This is particularly true given that RBOCs property records are not reliable.²² TELRIC is actually more readily administered and more reliable than the historical cost approach. TELRIC also helps overcome the "classical informational asymmetry problems between regulator and regulated."²³ Accordingly, based on ease of implementation, the Commission should avoid basing UNE pricing on "actual costs," especially if dependent on ILEC record keeping.

B. An Embedded Network Approach Has Already Been Considered and Rejected (*NPRM*, § IV.B.1.)

ILECs have a high hurdle in persuading the Commission to base UNE pricing on the incumbent LEC's actual costs and "currently available, forward-looking technologies,"²⁴ and on

²¹ *Id.*

²² The Commission has found that the BOCs have overstated their property costs by \$5 Billion. WC Docket No. 03-173, Letter from Joan Marsh, Director, Federal Government Affairs, to Marlene Dortch, Secretary, FCC, Mark T. Bryant Essay at 7.5 (December 8, 2003) ("Bryant Essay")

²³ D. Mark Kennet and Raul Perez-Reyes, *Beyond the Rhetoric: An Introduction to Implementing TELRIC*, Review of Network Economics, Vol. 1, Issue 2 at 162 (Sept. 2002).

²⁴ *TELRIC NPRM*, ¶ 53.

a network mix of new and older technology as opposed to instantaneous replacement of old technology with new technology.²⁵

In the *Local Competition Order*, the Commission explicitly rejected an actual network approach noting:

Under the [actual network] approach, the cost of interconnection and unbundled network elements would be based on existing network design and technology that are currently in operation. [FN1689] Because this approach is not based on a hypothetical network in the short run, incumbent LECs could recover costs based on their existing operations, and prices for interconnection and unbundled elements that reflect inefficient or obsolete network design and technology. This is essentially an embedded cost methodology.²⁶

Instead the Commission applied the following approach:

Under the third approach, prices for interconnection and access to unbundled elements would be developed from a forward-looking economic cost methodology based on the most efficient technology deployed in the incumbent LEC's current wire center locations. This approach mitigates incumbent LECs' concerns that a forward-looking pricing methodology ignores existing network design, while basing prices on efficient, new technology that is compatible with the existing infrastructure. This benchmark of forward- looking cost and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants. Moreover, this approach encourages facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC.²⁷

The *NPRM* proffers no basis to adopt the actual network approach described above. The *NPRM* does not demonstrate how use of this approach would now mitigate the effect of basing costs on inefficient or obsolete network technology, or how a focus on existing technology will suddenly more closely reflect the incremental costs incumbents will incur, or how such an approach would

²⁵ *TELRIC NPRM*, ¶ 50.

²⁶ *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket 96-98, First Report and Order, 11 F.C.C.R. 15499, ¶ 683 (1996) (“*Local Competition Order*”) (subsequent history omitted).

²⁷ *Local Competition Order*, ¶ 684.

better promote facilities-based competition. Advocates of an existing network approach face the high burden of demonstrating that it would lead to more appropriate cost-based rates. There appears to be little to show that an existing network approach would promote more facilities-based investment on the part of CLECs than the current TELRIC rules have.

Changed regulation, particularly in the face of uncontroverted evidence that the regulation is meeting the Commission's goal of increased telecom investment, must be consistent with the Commission's past practice and be reasonable.²⁸ In light of the Commission's previous evaluation, the Commission should retain the most efficient, forward looking network approach for setting UNE prices.

C. The Supreme Court Has Affirmed TELRIC (*NPRM*, § IV.B.)

The Commission should scrutinize ILEC proposed modifications to TELRIC in light of the fact that the Supreme Court strongly endorsed it and considered, and explicitly rejected, many of the ILECs arguments that they are attempting to recycle in this proceeding. The Court first observed the sea change that the Telecommunications Act of 1996 established with respect to historical approaches to ratemaking. The Court noted that under the local competition provisions of the Act, Congress called for ratemaking different from any historical practice, to achieve the entirely new objective of uprooting the monopolies that traditional rate-base methods had perpetuated."²⁹ This is reflected the admonition in Section 252 that a "rate-of-return or other

²⁸ *Association of Oil Pipe Lines v. Federal Energy Regulatory Commission*, 281 F.3d 239, 240-241, 248 (D.C. Cir. 2002).

²⁹ *Verizon*, 122 S.Ct. at 1660.

rate based” methodology may *not be used* to determine prices.³⁰ Rate-of-return proceedings are based upon use of historical costs.³¹

The Court noted that the Act was designed to promote “competition in the persistently monopolistic local markets, which were thought to be the root of natural monopoly in the telecommunications industry,” and sought to “eliminate the monopolies enjoyed by the inheritors of AT&T’s local franchises.”³² The Court noted that:

For the first time, Congress passed a ratesetting statute with the aim not just to balance interests between sellers and buyers, but to reorganize markets by rendering regulated utilities’ monopolies vulnerable to interlopers, even if that meant swallowing the traditional federal reluctance to intrude into local telephone markets.³³

The Court noted that from the “constancy of dissatisfaction’ with prior rate-making approaches:

one possible lesson was drawn by Congress in the 1996 Act, which was that regulation using the traditional rate-based methodologies gave monopolies too

³⁰ 47 U.S.C. § 252(d)(1)(A)(i) (emphasis added).

³¹ *See Illinois Bell Telephone Company v. FCC*, 988 F.2d 1254, 1258-59 (D.C.Cir. 1993)(“*Illinois Bell*”).

³² *Verizon*, 122 S.Ct. at 1654. The Court cited to one of the main proponents of the Act who noted that:

‘This is extraordinary in the sense of telling private industry that this is what they have to do in order to let the competitors come in and try to beat your economic brains outIt is kind of almost a jump-start I will do everything I have to let you into my business, because we used to be a bottleneck; we used to be a monopoly; we used to control everything. "Now, this legislation says you will not control much of anything. You will have to allow for nondiscriminatory access on an unbundled basis to the network functions and services of the Bell operating companies network that is at least equal in type, quality, and price to the access [a] Bell operating company affords to itself.’ 141 Cong. Rec. 15572 (1995). (Remarks of Sen. Breaux (La.) on Pub.L. 104-104 (1995)).

Id. at 1661.

³³ *Id.* at 1661.

great an advantage and that the answer lay in moving away from the assumption common to all the rate-based methods, that the monopolistic structure within the discrete markets would endure.³⁴

In fact, the fault with past historical actual cost rate making approaches was that they were often “no match for the capacity of utilities having all the relevant information to manipulate the rate base and renegotiate the rate of return every time a rate was set.”³⁵ While the RBOCs were migrated to price cap regulation, this did not eliminate the gamesmanship as “there are still battles to be fought over the productivity offset and allowable exogenous costs.”³⁶

The Court observed that the 1996 Act appears to be an “explicit disavowal of the familiar public-utility model of rate regulation (whether in its fair-value or cost-of-service incarnations) presumably still being applied by many States for retail sales . . . ***in favor of novel ratesetting designed to give aspiring competitors every possible incentive to enter local retail telephone markets***, short of confiscating the incumbents’ property.”³⁷ Such a ratemaking approach was necessary given the tremendous advantages that the RBOCs possessed.³⁸

³⁴ *Id.* at 1660.

³⁵ *Verizon*, 122 S.Ct. at 1660.

³⁶ *Id.* at 1660.

³⁷ *Id.* at 1661. (emphasis added)

³⁸ The Court chronicled how control over the local exchange gives ILECs a nearly insurmountable advantage:

A local exchange is thus a transportation network for communications signals, radiating like a root system from a "central office" (or several offices for larger areas) to individual telephones, faxes, and the like. It is easy to see why a company that owns a local exchange (what the Act calls an "incumbent local exchange carrier," 47 U.S.C. § 251(h)), would have an almost insurmountable competitive advantage not only in routing calls within the exchange, but, through its control of this local market, in the markets for terminal equipment and long-distance calling as well. A newcomer could not compete with the incumbent carrier to provide local service without coming close to replicating the incumbent's entire existing network, the most costly and difficult part of which

TELRIC, since it treated cost as a “forward-looking economic cost,” met the requirements of the Act because it was distinct from “historically based cost” which had generally been relied upon in valuing a rate base.³⁹ The Court in rejecting the RBOCs’ argument that the Act’s definition of cost must be based on their historical, actual costs astutely noted that “a merchant who is asked about the ‘cost of providing the goods’ he sells may reasonably quote the current wholesale market price, not the cost of the particular items he happens to have on his shelves.”⁴⁰ The Court observed that ratemakers often rejected the utilities “embedded costs” (their own book value estimates) “which typically were geared to maximize the rate bases with high statements of past expenditures and working capital, combined with unduly low rates of depreciation.”⁴¹ Thus, the Court concluded it would be “passing strange to think Congress tied ‘cost’ to historical cost without a more specific indication. . . .”⁴²

The Court went as far as to note that there even is an argument that the Act explicitly forbids embedded-cost methodologies, and that even though the Commission refrained from this interpretation, “it seems safe to say that the statutory language places a heavy presumption

would be laying down the “last mile” of feeder wire, the local loop, to the thousands (or millions) of terminal points in individual houses and businesses. The incumbent company could also control its local-loop plant so as to connect only with terminals it manufactured or selected, and could place conditions or fees (called “access charges”) on long-distance carriers seeking to connect with its network. In an unregulated world, another telecommunications carrier would be forced to comply with these conditions, or it could never reach the customers of a local exchange.

Verizon, 122 S.Ct. at 1662.

³⁹ *Id.* at 1664.

⁴⁰ *Id.* at 1666.

⁴¹ *Id.* at 1666.

⁴² *Id.* at 1667.

against any method resembling the traditional embedded-cost-of-service model of ratesetting.”⁴³

This is the presumption that Commission must overcome in promoting a methodology based on the ILECs’ actual costs.

Commenters are concerned that the Commission may be considering a return to the very type of ratemaking Congress proscribed in the 1996 Act. Any methodology rooted in the RBOC’s existing network deployment and technology is tethered to historical costs. For instance, the Commission suggests that it could use an approach akin to price cap regulation whereby it applies productivity and inflation factors to a carrier’s current expenses.⁴⁴ The carrier’s current expenses and actual costs, however, are their historical costs. Thus, the Commission potentially is reverting to a historical cost approach despite the Act’s admonition. The Court noted that Congress in proscribing traditional rate-of-return approaches was “firing a warning shot to state commissions to steer clear of entrenched practices perceived to perpetuate incumbent monopolies.”⁴⁵ Both this Commission, and state commissions, rightfully employed a pricing methodology designed to uproot, not perpetuate, monopolies. In considering any modifications to TELRIC, the Commission must ensure that the goal of uprooting monopolies is furthered, not diminished.

D. TELRIC Has Promoted Investment (*NPRM*, ¶ 3)

The Commission seeks comment on whether its “pricing methodology is working as intended and, in particular, whether it is conducive to efficient facilities investment.”⁴⁶ The

⁴³ *Verizon*, 122 S.Ct. at 1673.

⁴⁴ *TELRIC NPRM*, ¶ 11.

⁴⁵ *Verizon*, 122 S.Ct. at 1674, n. 31.

⁴⁶ *TELRIC NPRM*, ¶ 3.

Supreme Court unequivocally answered this question just over a year ago in *Verizon*. The Court rejected the notion that TELRIC does not spur investment. The Court noted that “the claim that TELRIC is unreasonable as a matter of law because it stimulates but does not produce facilities-based competition founders on fact.”⁴⁷ The Court observed that new entrants have invested in facilities to the tune of \$55 billion from the passage of the Act to 2000. As of 2002, that figure had increased to \$71 billion.⁴⁸ CLECs reinvest a much larger portion of their revenues back into their facilities than the RBOCs, 63.7% to 20.6% respectively.⁴⁹

The Court also observed that FCC statistics indicate substantial resort to pure and partial facilities-based competition among the three entry strategies: as of June 30, 2001, 33 percent of entrants were using their own facilities; 23 percent were reselling services; and 44 percent were leasing network elements (26 percent of entrants leasing loops with switching; 18 percent without switching).⁵⁰ As of the end of 2002, CLECs provided about 26% of their switched access lines over their own loop facilities.⁵¹ The Court concluded that “it suffices to say that a regulatory scheme that can boast such substantial competitive capital spending over a 4-year

⁴⁷ *Verizon*, 122 S.Ct. at 1675.

⁴⁸ *See Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, CC Docket Nos. 02-33, 01-318, 01-321, Letter from Jonathan Askin, General Counsel, Association for Local Telecommunications Services, to Marlene H. Dortch, Secretary, FCC, Attach. at 11 (filed July 17, 2003).

⁴⁹ *Verizon*, 122 S.Ct. at 1675.

⁵⁰ *Id.* at 1675.

⁵¹ *Local Telephone Competition: Status as of December 31, 2002*, Industry Analysis and Technology Division, Wireline Competition Bureau at 2 (June 2003).

period is not easily described as an unreasonable way to promote competitive investment in facilities.”⁵² TELRIC has clearly been conducive to facilities-based investment by CLECs.

TELRIC also has not stymied RBOC investment. During the same period, the RBOCs invested over \$100 billion. One analysis of investment found that:

Each 1% *reduction* in UNE rates corresponds with rigorous statistical significance to approximately a 2.1% to 2.9% *increase* in ILEC investment. Thus, raising TELRIC or restricting access to UNEs, as the ILECs advocate would *both* reduce the competitive alternatives available to consumers *and* reduce the ILECs’ capital spending on their own networks.⁵³

The Commission, however, has invoked a similar concern to that raised by the D.C. Circuit, *i.e.*, “the existence of investment of a specified level tells us little or nothing about incentive effects. The question is how such investment compares with what would have occurred under a different regulatory regime.”⁵⁴ In this connection, the period after which TELRIC pricing rules were implemented has seen much more investment than what was to be expected. The Phoenix Center reported that the *additional* telecommunications investment, *i.e.*, over and above what was expected, from 1996 to 2001 was in the range of \$267 billion.⁵⁵ From 1980 to 1995, telecommunications investment grew at an annual rate of 2.8%, with an average annual investment level of approximately \$39 billion. After the 1996 Act, investment grew at an average annual rate of 22.3% with about \$95.3 billion being invested annually.⁵⁶ Statistics also demonstrate that the RBOC total plant in service continues to rise, and RBOCs invest more

⁵² *Verizon*, 122 S.Ct. at 1676.

⁵³ Willig Essay at 3.10 (emphasis in original).

⁵⁴ *United States Telecom. Ass’n v. FCC*, 290 F.3d 415, 425 (D.C. Cir. 2002).

⁵⁵ Phoenix Center Policy Bulletin No. 5, Competition and Bell Company Investment in Telecommunications Plant at 1 (July 9, 2003) (Phoenix Center Bulletin No. 5).

⁵⁶ Phoenix Center Bulletin, No. 4, The Truth About Telecommunications Investment at 3 (June 24, 2003) (Phoenix Center Bulletin No. 4).

significantly in states where there is competition.⁵⁷ Thus, it also clear that TELRIC promoted greater investment than what would have been reasonably expected based on the pre-1996 Act regulatory regime.⁵⁸

While it is true that investment has declined in the last two years this has been more the function of a sluggish economy, closed capital markets, and diminished network needs as opposed to a response to TELRIC prices. Verizon attributes its reduction in capital expenditure to “effective management of our capital expenditure budget to current network demand.”⁵⁹ Verizon’s capital spending was still nearly \$7 billion in 2002.⁶⁰ In fact, Verizon recently completed year one of an ambitious plan to expand its high-speed data network and has already added over 6,800 fiber miles to its network in one year alone.⁶¹ BellSouth also attributed decreases in capital spending to decreases in demand.⁶² This decrease is not surprising. Studies show that investment by telecommunications firms is caused by economic growth, but not vice

⁵⁷ Phoenix Center Bulletin No. 5 at 4.

⁵⁸ Application of long run incremental cost models in other countries corroborate the U.S. experience. In Denmark, in the five years after the Danish market was liberalized and cost based interconnection rates were introduced, competition developed in most markets and there was no indication of any slow down in investment caused by low rates for interconnection services. In the same period, there was considerable growth in telecom investments not only by new entrants, but also by the monopoly provider, TDC. Morten Falch, *TELRIC – the way towards competition? An European point of view*, Review of Network Economics, Vol. 1, Issue 2 at 151-152 (Sept. 2002). The Organization for Economic Cooperation and Development (OECD) has found that in the thirty developed countries that comprise its membership, “the evidence indicates that opening access networks, and network elements, to competitive forces increases investment and the pace of development.” Willig Essay at 3.12.

⁵⁹ Verizon Communications, Inc., 2002 Annual Report 26 (2003).

⁶⁰ *Id.*

⁶¹ *Verizon Extends Winning Streak, Signing over 900 Contracts for Enterprise Advance Services in First Year*, Verizon News Center Press Release (Nov. 20, 2003).

⁶² BellSouth 2002 Annual Report 37 (2003).

versa.⁶³ Capital expenditures are also down because there is less capital to invest. In addition, it is also expected that after a spurt of initial investment, investment will decline once initial network construction nears completion.⁶⁴

The Court also rejected the idea that TELRIC should be tweaked to promote ILEC investment. The Court noted that the RBOCs argued that some degree of long-run inefficiency ought to be preserved in order to give an entrant an efficient alternative to leasing, *i.e.*, building its own facilities. The Court noted the inherent flaw in this approach was that it perpetuates economic inefficiency and creates barriers to entry.⁶⁵

E. TELRIC Permits ILECS To Recover Their Costs (*NPRM*, ¶ 40)

⁶³ Phoenix Center Bulletin No. 5 at 8, *citing*, R.O. Beil, G.S. Ford, and J.D. Jackson, *On the Relationship between Telecommunications Investment and Economic Growth in the United States* (June 2003).

⁶⁴ Phoenix Center Bulletin No. 5 at 7.

⁶⁵ The Court observed that:

The first objection turns on the fact that a lease rate that compensates the lessor for some degree of existing inefficiency (at least from the perspective of the long run) is simply a higher rate, and the difference between such a higher rate and the TELRIC rate could be the difference that keeps a potential competitor from entering the market. See n. 27, *infra*. Cf. First Report and Order ¶ 378 ("[I]n some areas, the most efficient means of providing competing service may be through the use of unbundled loops. In such cases, preventing access to unbundled loops would either discourage a potential competitor from entering the market in that area, thereby denying those consumers the benefits of competition, or cause the competitor to construct unnecessarily duplicative facilities, thereby misallocating societal resources"). If the TELRIC rate for bottleneck elements is \$100 and for other elements (say switches) is \$10, an entering competitor that can provide its own, more efficient switch at what amounts to a \$7 rate can enter the market for \$107. If the lease rate for the bottleneck elements were higher (say, \$110) to reflect some of the inefficiency of bottleneck elements that actually cost the incumbent \$150, then the entrant with only \$107 will be kept out. Is it better to risk keeping more potential entrants out, or to induce them to compete in less capital-intensive facilities with lessened incentives to build their own bottleneck facilities? It was not obviously unreasonable for the FCC to prefer the latter.

Id. at 1672.

ILECs continue to contend that TELRIC does not allow them to adequately recover their costs. Two economists who studied the profitability of ILECs since the enactment of the 1996

Act found:

Given the rates-of-return on regulated investment, and the rates-of-return on embedded investment, it seems clear that the majority of telephone companies in the survey are earning returns that are more than sufficient to assure confidence in the financial integrity of their enterprises, maintain their credit worthiness and to enable them to attract additional capital. Based on this data it would seem that the ILECs and their supporters' contention, that use of the TELRIC methodology, on its face, results in a taking, is not grounded in the reality depicted by their earnings reports.⁶⁶

Another study found that RBOC wholesale margins remain positive with the RBOC's EBITDA margins in percentage terms (revenues minus cost divided by revenue) for retail and wholesale services averaging 55% and 40% respectively.⁶⁷ The RBOCs have failed to show that, even if they are entitled to recovery of any unrecovered costs, TELRIC fails to provide them with constitutionally adequate compensation.

All that is necessary to ensure full compensation is that rates provide the opportunity to recover costs as they would be evaluated in a competitive market.⁶⁸ Forward-looking pricing provides the compensation that an ILEC could expect if it were operating in an effectively competitive market.⁶⁹ In a competitive market, costs are based on the most efficient technology

⁶⁶ Gabel/Rosenbaum at 265.

⁶⁷ Dr. George S. Ford and T. Randolph Beard, *What Determines Wholesale Prices for Network Elements in Telephony? An Econometric Evaluation*, Phoenix Center Policy Paper Number 16 at 4 (Sept. 2002).

⁶⁸ WC Docket No. 03-173, Letter from Joan Marsh, Director, Federal Government Affairs, to Marlene Dortch, Secretary, FCC, William J. Baumol Essay at 2.10 (December 4, 2003) ("Baumol Essay")

⁶⁹ Baumol Essay at 2.5

currently available, not on embedded costs.⁷⁰ In fact, the Commission's TELRIC pricing rules allow ILECs a greater return than what they could expect in a competitive market by basing prices on existing switch locations, as opposed to the most efficient locations, and only requiring consideration of current efficient costs as opposed to costs that can reasonably be expected to be achieved by ILECs via future productivity improvements.⁷¹ If a competitive market expects prices and values to decline it will reflect this in its prices for current equipment.⁷²

In fact, it is premature to consider if there will be a shortfall. As noted in the *Local Competition* proceeding, "the size of any shortfall between historical costs and TSLRIC's forward-looking costs will not be determined for many years after interLATA entry." *Local Competition Order*, ¶ 655.

In considering any issue of allegedly unrecovered costs, the Commission should not ignore the tremendous aid given to ILECs in the deployment of their ubiquitous networks. ILECs were allowed to deploy their own networks at their own speed and without competition for many years with a guaranteed rate-of-return. As a recent study by Economics and Technology, Inc. observed, "the RBOCs and other ILECs enjoy enormous advantages stemming directly from the basic scale economies and 'first mover' advantages deriving from their *incumbency* positions in the local telecommunications market."⁷³ ETI found that as of December 2001, the total market capitalization of the RBOCs was \$345.8 billion representing a market

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.* At 2.8.

⁷³ Lee L. Selwyn, *Subsidizing the Bell Monopolies: How Government Corporate Welfare Programs are Undermining Telecommunications Competition* at 3 (April 2002) ("ETI Study").

premium over book value of \$264.4 billion. ETI noted that this premium can be “traced to the firm’s acquisition of valuable business assets at less than their market value or perhaps at no cost at all.”⁷⁴ After divestiture, the RBOCs were “gifted valuable assets and earnings opportunities, enabling them to generate significant additional profits far in excess of what would be permissible under the traditional ‘competitive price’ standard of public utility regulation.”⁷⁵ RBOCs were granted “valuable public resources – electromagnetic spectrum and the use of public rights-of-way – without any payment to the government and with the right to exploit such gifted assets without any price regulation or earnings constraints.”

The RBOCs have “been permitted to exploit legacy monopoly relationships with customers and other legacy assets to develop and expand into new nonregulated lines of business, without any obligation to compensate the regulated portion of their operations for the fair market value of those assets.”⁷⁶ The RBOCs have been “largely insulated from any serious competitive losses through a variety of funding mechanisms that have shifted preexisting sources of excess profits into fees and other charges that are imposed upon competitors.”⁷⁷ These fees not only “make the RBOCs whole with respect to any actual competitive ‘losses’ they may sustain, but concurrently increase competitors’ costs and make their entry and success all the more difficult.”⁷⁸ Under price cap regulation, RBOCs “continue to earn in excess of 425% on their *interstate* services – a monopoly earnings level that could not be sustained under

⁷⁴ *Id.* at 25.

⁷⁵ *Id.*

⁷⁶ *Id.* at 27.

⁷⁷ *Id.*

⁷⁸ *Id.*

competitive market conditions.”⁷⁹ Thus, the benefits, both tangible and intangible, that the ILECs have enjoyed have greatly facilitated the deployment of their networks. CLECs meanwhile have to attempt to deploy alternative facilities in the context of competition for funds not only from the RBOCs, but other CLECs as well, with no assurance of any return on their investment. CLECs clearly need correct pricing in regard to hard-to-duplicate network elements to extend their network reach. UNEs provide a path to facilities-based competition by allowing competitors to share in ILEC economies of scale for those facilities for which deployment of alternative facilities is not economically feasible. Through this leasing, CLECs can acquire a customer base and adequate scale to justify investment in their own facilities.⁸⁰

Moreover, prior to the implementation of the Act, the RBOCs had no assurance that they would fully recover their costs (assuming *arguendo* that there were any unrecovered costs). For instance, the New York Public Service Commission denied recovery of stranded costs to companies operating under incentive regulation plans, such as New York Telephone and Rochester Telephone, that “gain opportunities for greater earnings” under such plans but also “bear the risk of poor earnings and stranded revenue.”⁸¹ NARUC recommended in 1996 that companies operating under price cap regulation not be allowed to recover their stranded investment costs.⁸² In 1995, before the enactment of the 1996 Act, BellSouth reported a writedown of \$2.7 billion because “it is doubtful that regulated rates sufficient to recover the net

⁷⁹ *Id.* at 5.

⁸⁰ Willig Essay at 3.6.

⁸¹ *Transition to Competition in the Local Exchange Market*, NY PSC Case No. 94-C-0095, Opinion No. 96-13, 1996 WL 302398, *55 (1996); *see also*, *Local Competition Order*, ¶ 656.

⁸² NARUC Staff Subcommittee on Communications, *Local Competition Work Group Summary Report* at 52-53 (1996); CC Docket No. 96-98, AT&T Comments at 71-72, n. 105.

book value of telephone plant could be charged to and collected from customers due to expected levels of future competition.”⁸³ Thus, even the RBOCs had no expectation of fully recovering their embedded costs, and regulators certainly were not giving them this impression.

In fact, the FCC noted that other than advancing figures of stranded costs for which they provided no basis, no ILEC had “provided persuasive evidence that prices based on a forward-looking economic cost methodology would have a significant impact on its ‘financial integrity,’” which is the relevant standard under *Illinois Bell*.⁸⁴ The FCC left the door open for ILECs to make such a showing, and if they were able to do so, they could petition to seek relief from the methodology.⁸⁵ No ILEC has even attempted to make such a showing of significant stranded costs.⁸⁶ The ILECs are also provided an opportunity to demonstrate to a court that the rates are confiscatory, but no ILEC has been able to demonstrate that to date. Nevertheless, the ILECs always retain the opportunity to do so.⁸⁷

It would be very difficult for the RBOCs to quantify their actual costs, much less demonstrate that there are unrecovered costs. The FCC correctly concluded that based on the record before it that there was no support for the claim that significant residual costs would result from the use of a forward-looking methodology.⁸⁸ As a commenter in the *Local Competition*

⁸³ BellSouth Corporation, Securities and Exchange Commission Form 10-K, Annual Report at 34 (1995); AT&T Comments at 71-72, n. 105.

⁸⁴ *Local Competition Order* at ¶ 738.

⁸⁵ *Id.* ¶ 739.

⁸⁶ Jim Chen, *Standing in the Shadows of Giants: The Role of Intergenerational Equity in Telecommunications Reform*, 71 U. Colo. L. Rev. 921, 935 (2000)

⁸⁷ *Local Competition Order*, ¶ 739.

⁸⁸ *Local Competition Order*, ¶ 707.

proceeding noted, “nominal losses in economic value attributed to stranded investment should be weighed against the appreciation in value that incumbent LECs have experienced in share prices and market-to-book ratios.”⁸⁹ RBOCs have claimed that they have had to carry reserve deficiencies as a result of lengthy depreciation schedules dictated by regulatory bodies, but the market data belies this claim. The limited available market data “clearly shows that the book value of the ILEC assets is significantly less than the market value of the assets.”⁹⁰ As some economists conclude, “the fact that ILEC exchange assets are commanding prices on the open market which are of a magnitude greater than their book value vitiates the ILECs’ contention that implementation of TELRIC will result in stranded costs.”⁹¹

There are also mechanisms built into TELRIC to ensure adequate cost recovery. As the FCC noted, TELRIC provides an adequate return to the RBOCs because “properly designed depreciation schedules should account for expected declines in the value of capital goods.”⁹² If depreciation and cost of capital are calculated appropriately, firms can recover the costs of efficient investments.⁹³ As two economists have noted, a formula not based on a firm’s actual cost can recover all of the firm’s costs because “conceptually, historical costs should be identical

⁸⁹ *Local Competition Order*, ¶ 659.

⁹⁰ *Gabel/Rosenbaum* at 266.

⁹¹ *Id.*

⁹² *Local Competition Order*, ¶ 686.

⁹³ Gregory L. Rosston and Roger G. Noll, *The Economics of the Supreme Court’s Decision on Forward Looking Costs*, Review of Network Economics, Vol. I, Issue 2 at 84 (Sept. 2002).

to forward-looking costs if firms minimize actual costs and if true economic depreciation and risk adjustment rates are used.”⁹⁴

Contrary to RBOC contentions, TELRIC has not yielded massive price reductions by maintaining low-risk cost of capital and extended depreciation rates transplanted from the monopoly regime. The Commission clearly encouraged states to use cost-of-capital and depreciation rates that would adequately cover the RBOCs’ cost of capital and accurately reflect the economic lives of their facilities.⁹⁵ The implementation of TELRIC has borne this out. For instance, the FCC had opined that its proposed cost-of-capital figures of 11.25% may have been too high given the current marketplace cost-of-equity and debt, but it opted for a forward-looking figure that would generate higher costs than warranted by the actual state of competition.⁹⁶ Thus, far from being restricted to use of depreciation rates and cost of capital from the monopoly regime, the RBOCs have been pushing for, and often receiving, forward-looking depreciation rates and costs of capital that go beyond the competitive risks they face.

⁹⁴ *Id.*

⁹⁵ *Local Competition Order*, ¶ 702.

⁹⁶ *Id.* The Massachusetts Department of Telecommunications and Energy went beyond the high FCC figure and utilized a cost of capital of 12.16 percent that was higher than the cost of capital it has used in setting Verizon’s retail local rates. *Application of Verizon New England Inc., et al., for Authorization to Provide In-Region, InterLATA Services in Massachusetts*, CC Docket No. 01-9, Memorandum Opinion and Order, FCC 01-130, 2001 WL 388287, ¶ 38 (Apr. 16, 2001). The Indiana Utility Regulatory Commission (“IURC”) likewise allowed for the economic lives that were substantially shorter than those prescribed by the FCC, and shorter than those suggested by the historical life indications of Ameritech’s existing facilities, in order to reflect a possible need to upgrade equipment more quickly to compete in an evolving market. *In re Commission Investigation and Generic Proceeding on Ameritech Indiana’s Rates for Interconnection, Unbundled Elements, and Transport and Termination Under the Telecommunications Act of 1996 and related Indiana Statutes*, IURC Cause No. 40611, Order, 1998 WL 999945, 9-10 (1998).

The RBOCs conceded to the Supreme Court that interstate access and long distance charges are two sources of revenue that could provide recovery for otherwise unrecovered costs.⁹⁷ For instance, access charges for years have been set well in excess of the RBOCs' economic costs of providing access service to provide subsidies for universal service.⁹⁸ Likewise, the RBOCs' entry into the interLATA market has already provided, and will continue to provide, substantial revenue that should more than compensate for any nominal unrecovered cost there may be. It should not be forgotten that the RBOCs were among the supporters of the 1996 Act, and it is reasonable to believe that it was their recognition of the lucrative benefits of interLATA entry that fueled this support.⁹⁹ Thus, RBOCs could use revenues from one of these areas to offset any deficiency that arises from UNE rates, if such a deficiency is ever demonstrated by the RBOCs.¹⁰⁰

For all these reasons, TELRIC permits ILECs to recover their costs.¹⁰¹

⁹⁷ Brief for Petitioners BellSouth Corporation, *et al.*, at 36, n. 15, *Verizon Communications, Inc. v. FCC*, 122 S.Ct. 1646 (No. 00-511) (2002).

⁹⁸ Alfred Kahn & William Shew, *Current Issues in Telecommunications Regulation: Pricing*, 4 Yale J. Reg. 191, 193-95, 202, n.28 (1987).

⁹⁹ See, P.L. 104-104, S. Rep. 104-23 at 26-29 (1995).

¹⁰⁰ See, *Qwest Corporation v. U.S.*, 48 Fed.Cl. 672, 696 (2001). The Court of Federal Claims noted that Plaintiff Qwest's physical takings claim must be considered in the "context of the comprehensive legal framework established by the Telecom Act." *Id.* The court noted that the Telecom Act "created a matrix of interlocking opportunities for ILECs" where "they could enter some new markets, but the *quid pro quo* was that they open up their own local exchange markets to competition." *Id.*; see also, *National Railroad Passenger Corp. v. Boston and Maine Corp.*, 503 U.S. 407, 418 (1992) (upholding broad construction by Interstate Commerce Commission of its condemnation authority that implemented and interpreted the statute in a manner that comports with its words and structure).

¹⁰¹ See, *Verizon*, 122 S.Ct. at 1677-1678.

V. THE ATTACHED REPORT PROVIDES AN APPROPRIATE BASIS FOR UNE PRICING (*NPRM*, § IV.B.)

While TELRIC is correctly based on a forward looking approach to setting UNE prices, there are ways in which it may be modified to enable the Commission's pricing rules to establish more accurate cost based rates and thus promote efficient economic investment. The attached report by Bridger Mitchell, Charles River Associates, discusses in greater detail proposed modifications. The proposed modifications will address ILEC concerns by modifying TELRIC to reflect important real-world attributes of investment decision making and principles of efficient pricing. The principal recommended modifications to the TELRIC methodology include provisions to increase investment and capacity during the lifetime of assets, and recognition of variable utilization rates as output grows over time.¹⁰²

As explained in the attached report, TELRIC could be improved by taking more directly into account some attributes of the ILECs' networks. For instance, the routing of cables in an actual network should reflect the condition of topography in local markets.¹⁰³ The accuracy of the underlying data, however, needs to be verified. Past Commission investigations have shown that this data is either non-existent, incomplete or inaccurate. Thus, as a threshold matter, ILECs would need to undertake the data collection necessary to determine accurately their network configurations.¹⁰⁴ It is also worth noting that ILECs are likely to seek to use actual network characteristics to an inappropriate degree.

¹⁰² Mitchell Report at 2-3, 10-13.

¹⁰³ Mitchell Report at 10.

¹⁰⁴ WC Docket No. 03-173, AT&T *Ex Parte* Presentation at 6 (Oct. 8, 2003).

Current TELRIC rules also lead to use in TELRIC models of utilization rates that are too low. As a result, TELRIC costs are calculated based on excess spare capacity leading to TELRIC prices that are inefficiently high. Dynamically-efficient fill factors will lower the efficient price of local loops, due to growing demand and increased unit investment cost over time.¹⁰⁵

Cost-of-capital may vary, and should be applied separately, based on type of facility. For loops, high entry barriers posed by ILEC sunk-cost and fixed-cost advantages will lead CLECs to generally lease loop facilities as opposed to duplicating inefficiently these facilities. Thus, for loop plant there is a minimal risk of stranded investment. For other elements such as switching and database services, the entry barriers are lower, and therefore may pose a greater risk to ILEC investment. To properly reflect dissimilar ILEC investment risks for different UNEs, the cost-of-capital used to evaluate efficient investment in loops should be lower than the cost-of-capital used for other UNEs in a TELRIC analysis.¹⁰⁶

Non-recurring costs (“NRCs”) are those costs associated with the activities required in the initiation and provisioning of wholesale services, interconnection, or unbundled network elements. As in the case of recurring charges, the FCC’s pricing rules allow for the recovery of only those costs incurred in connection with “a reconstructed local network [that] will employ the most efficient technology for the reasonably foreseeable capacity requirements.”¹⁰⁷ Under this approach, the Commission requires that both recurring and non-recurring charges for access to unbundled network elements must be “developed from a forward looking economic cost

¹⁰⁵ Mitchell Report at 11-13.

¹⁰⁶ Mitchell Report at 14-15.

¹⁰⁷ *Local Competition Order*, ¶ 685.

methodology based on the most efficient technology deployed in the incumbent LEC's current wire center locations.”¹⁰⁸

The Commission also must ensure that nonrecurring charges applied by ILECs are limited to forward-looking charges and exclude charges for making network modifications that would bring the ILEC network up to the standard assumed in the forward looking network model. These are not forward-looking costs, however, and should be disallowed in a TELRIC methodology.

For example, as explained in the attached report, CLECs purchasing loops are entitled to loops that meet best-practice standards. The presence of load coils, bridged taps and other impairments that limit the technical quality of service on loops does not conform with industry best practice or network engineering guidelines. Loop conditioning costs are a one-time ILEC capital cost that is required to update a legacy distribution technology to the standard of current best practice. Since these loop conditioning costs are not forward-looking costs that would be incurred by an efficient network operator they should not be included in calculating the forward-looking cost of the distribution plant and an efficient UNE loop price.¹⁰⁹

TELRIC cost models demonstrate that subscriber density is perhaps the single most important cause of cost variation between local service areas. In order for UNE prices to provide efficient signals of investment costs, prices should vary by subscriber density and service area topography. Rates averaged across areas with differing costs would distort investment incentives. In lower cost areas, entrants would have incentives to construct their own facilities, thereby duplicating ILEC assets, rather than to lease UNEs at prices above efficient costs. Thus,

¹⁰⁸ *Id.*

¹⁰⁹ Mitchell Report at 15-16.

if dissimilar UNE costs were averaged into a uniform prices, inefficient investment would be encouraged.¹¹⁰

The Commission should promptly implement all of these changes recommended in the attached Mitchell Report.

¹¹⁰ Mitchell Report at 17-18.

VI. THE COMMISSION SHOULD REQUIRE THAT ILECS IMPUTE UNE PRICES TO THEIR OWN RETAIL RATES (*NPRM*, § IV.H.)

The Commission should require that UNE rates are imputed to retail rates. This is necessary to preclude an ILEC from reducing its retail price until the margin between the ILEC's retail price for a service and the cost of the underlying UNEs is diminished to a point where the ILEC is not covering the costs it charges to CLECs and its own retailing costs. This would create a "price squeeze" such that the CLEC could not effectively compete with the ILEC. Various state commissions, including the Massachusetts Department of Telecommunications and Energy and the Indiana Utility Regulatory Commission, have required such imputation to ensure consistent costing principles between retail and wholesale rates.¹¹¹ Other states, such as Illinois, legislatively mandate imputation. The Commission, in the *Local Competition Order*, recognized that an imputation rule would be pro-competitive and useful in detecting price squeezes.¹¹² The Commission should take this opportunity to now require that ILEC retail rates impute the ILEC's UNE prices, and to preempt any individual state law provision that attempts to circumvent the imputation requirement.¹¹³

¹¹¹ *Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Regulatory Plan to succeed Price Cap Regulation for Verizon New England, Inc. d/b/a Verizon Massachusetts' intrastate retail telecommunications services in the Commonwealth of Massachusetts*, D.T.E. 01-31—Phase II, Order at 32-33 (April 11, 2003); *Re Access Charge Reform and Universal Service Reform*, Cause Nos. 40785-S1, 40849, and 41058, Order, 2001 WL 798600, * 9 (2001).

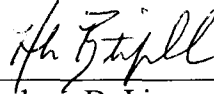
¹¹² *Local Competition Order*, ¶¶ 848, 850.

¹¹³ The importance of imputation and a clear federal preemption on this issue was amply demonstrated in Illinois in 2003. Through its unmatched political muscle, SBC Illinois was able to achieve passage and enactment of SB 885 that resulted in more than a 300% increase in UNE prices, including UNE Loops. This bill was passed and signed into state law by the Governor in a mere four (4) days after its introduction over the objections of consumer

VII. CONCLUSION

Accordingly, if the Commission adopts any changes to UNE pricing rules it should do so consistent with the recommendations in these comments.

Respectfully submitted,



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groups, the State Attorney General and competitive carriers. One of the key anti-competitive provisions in this legislation was the exemption of any UNE price increase resulting from the application of the legislative mandates from the state's imputation requirement. Although this law was subsequently permanently enjoined by the Federal District Court on appeal, it demonstrates how tenuous the FCC's pricing rules are to a well funded political apparatus.

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December 16, 2003

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